93-SBE-003

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 89A-0831-CD
UNION CARBIDE CORPORATION	)	

Appearances:

For Appellant:	Ira P. Klein Senior Tax Counsel
	James P. Kleier Attorney at Law
For Respondent:	Karen D. Smith Cody Cinnamon Counsels

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Union Carbide Corporation against proposed assessments of additional franchise tax in the amounts of $292,313, $261,473, $569,090, $352,129, $513,225, and $554,043 for the income years 1974, 1975, 1976, 1977, 1978, and 1979, respectively.[2/]

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

[2/] As the result of a payment by appellant and various concessions by the parties, the exact amount remaining in controversy is unclear but has been considerably reduced from that stated in the proposed assessments. The amount in controversy now represents only the dispute regarding the government-owned property used in appellant's unitary business.

The two issues presented by this appeal are (1) whether property owned by the federal government but used at no charge by appellant as part of its unitary business is properly included in the denominator of appellant's property factor, and (2) if such property is properly included, whether appellant has correctly calculated the amount to be included.[3/]

Appellant and its affiliates were engaged in the single unitary business of research, development, and manufacturing of chemical, nuclear, and other products during the appeal years. As a part of its unitary business, appellant managed and operated government-owned nuclear research and production facilities for the federal government at Oakridge, Tennessee, and Paducah, Kentucky ("GOPO property").[4/] The federal government paid appellant a yearly fixed fee for managing and operating the GOPO property and reimbursed appellant for its costs. Apparently, appellant also developed its own commercial products as a result of research connected with its use of the GOPO property. The federal government did not charge appellant for appellant's use of the GOPO property.

In a previous appeal involving the GOPO property under circumstances identical to those in the instant appeal, this board held that respondent must apply its regulation 25137, subdivision (b)(1)(B), and permit appellant to include in the denominator of its property factor a value for the GOPO property. (Appeal of Union Carbide Corporation, Cal. St. Bd. of Equal., Apr. 5, 1984 ["Union Carbide I"].) Respondent now attempts to relitigate the issue decided in Union Carbide I by contending that the GOPO property should not be included in appellant's property factor because appellant did not have a possessory interest in that property. In support of its contention, respondent relies on this board's decisions in the Appeal of Retail Marketing Services, Inc., decided August 1, 1991, and the Appeal of Castle & Cooke, Inc., et al., decided June 17, 1987. However, respondent's reliance on these appeals is misplaced. Although these appeals were decided after Union Carbide I, neither appeal was concerned with regulation 25137, subdivision (b)(1)(B), and we are not at all persuaded that the reasoning of either appeal should be extended to reach the result advocated by respondent in this matter. Therefore, we reject respondent's contention, reaffirm this board's holding in Union Carbide I, and apply that holding to the income years in this matter.

Because we have concluded that the GOPO property is properly included in appellant's property factor, we must consider the valuation issue.[5/] This board indicated in Union Carbide I that the value for the GOPO property to be included in the appellant's property factor is determined under section 25130 and regulation 25137, subdivision (b)(1)(B). Section 25130 states that the value of

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[3/] Appellant also contends that it is entitled to reimbursement under the Taxpayers' Bill of Rights for its fees and expenses resulting from respondent's allegedly unreasonable action in this appeal. However, it is premature for the board to consider this question since, among other things, appellant has not filed a claim with the State Board of Control for fees and expenses. (Rev. & Tax. Code, § 21013, subd. (a)(1).)

[4/] It appears undisputed that, at least during the appeal years, the GOPO property could be owned only by the federal government.

[5/] The value of the GOPO property was not at issue in Union Carbide I.

rented property is determined by multiplying the "net annual rental rate" of the property by eight. The "net annual rental rate" for property owned by others and used by the taxpayer at no charge is determined on the basis of a "reasonable market rental rate" for such property. (Cal. Code Regs., tit. 18, reg. 25137, subd. (b)(1)(B).)

The "reasonable market rental rate" referred to in the regulation cited above is not defined by statute, respondent's regulations, or any other authority of which we are aware. However, we agree with the common sense proposition that the "reasonable market rental rate" for the GOPO property should be what a "willing lessor" of that property (which must, in our view, be the federal government because of restrictions on ownership of the GOPO property) could reasonably expect to receive from a "willing lessee" after arm's-length bargaining. As a result, an acceptable valuation approach for determining a reasonable market rental rate for the GOPO property is one that reasonably approximates that amount. In this matter, each party has used its own valuation approach and supported that approach with an appraisal.

In its appraisal, respondent indicates that it determines reasonable market rental rates for the GOPO property by multiplying what it considers the fair market value of that property during each appeal year by a factor that appears to be related to appellant's management function with regard to the property. (Resp. Br., Ex. A at viii-xvi.) The testimony of respondent's appraiser makes clear that the product of these two numbers is intended to represent the amount that appellant should reasonably have received for managing and operating the GOPO property for the federal government during the appeal years. (Tr., Oct. 9, 1991, at 23-31.) In view of the foregoing, it is apparent that respondent equates the reasonable market rental rate for use of the GOPO property with a reasonable fee for managing the property for the federal government. Underlying the equation of these amounts is the assumption that the benefits received by a prospective lessee would be restricted to reasonable fees for managing the property. However, as we discuss below, there are significant benefits other than management fees that would be available to a lessee of the property. Because respondent valued only reasonable management fees payable to a lessee and did not take into account these significant benefits, we must conclude that respondent's valuation approach did not reasonably approximate what the federal government could expect to receive from a willing lessee, and, therefore, respondent did not determine the reasonable market rental rates for the GOPO property.

Appellant determines the reasonable market rental rates for the GOPO property by multiplying its version of the fair market value of the property in each appeal year by a

capitalization factor. This factor is derived from a discount rate[6/] adjusted for interest expense, income tax, depreciation, property tax, and projected inflation. (App. Reply Br., Ex. A at 12-18.) The resulting product is intended by appellant to represent the return that a prudent investor would require on an investment in the GOPO property and, as a result, the amount of rent that such an investor leasing the property would require from a lessee. (App. Reply Br., Ex. A at 12.) Multiplying the fair market value of property by such a capitalization factor is an accepted valuation approach for approximating the rent that a lessor could reasonably expect to receive from a lessee of that property. (See, e.g., Procacci v. Commissioner, 94 T.C. 397, 407-408, 412-413 (1990).)

Respondent argues, in part, that appellant's valuation approach is unreasonable under the circumstances in this appeal because a prudent lessee of the GOPO property would not be willing to pay enough rent to cover the costs of the lessor's investment in that property. However, respondent's argument again assumes that a lessee's benefits with regard to the GOPO property would be restricted to reasonable fees for managing the property and does not take into account other benefits, such as commercially exploitable increases in technical and scientific knowledge, that would accrue almost inevitably from a lessee's use of the property. Although respondent disputes that appellant actually received significant amounts of revenue during the appeal years from commercial products developed in connection with appellant's use of the GOPO property, it has not persuaded us that a prudent lessee could not have ultimately received substantial enough commercial benefits to justify payment in the appeal years of the rental rates determined under appellant's valuation approach.

Respondent also criticizes as unreasonable specific aspects of appellant's computation of the reasonable market rental rates of the property. With regard to the capitalization factor selected by appellant, respondent argues that several of its elements should be excluded from the computation or modified. Although not all of the arguments by the parties are adequately developed, it is clear to us that some of these elements should be excluded from computation of appellant's capitalization factor. Since the federal government pays no income or property taxes, we agree with respondent that these taxes should not be considered in computing the capitalization factor. In addition, we agree with respondent that depreciation should be excluded from the factor because it is considered elsewhere in appellant's computation. Respondent's criticisms of appellant's appraisal of the fair market value of the GOPO property are either undercut by the testimony of respondent's own appraiser, result in no change that would be helpful to respondent's position, or are otherwise sufficiently rebutted by appellant. Therefore, we see no need to make any modifications there.

After the foregoing changes are taken into account, we conclude that appellant's valuation approach results in a reasonable approximation of rents that the federal government could reasonably expect to receive from a lessee of the GOPO property during the appeal years. As a result,

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[6/] In essence, a "discount rate" in this context is the required rate of return by a reasonable investor on his investment net of adjustments of the kind described in the text above. (See Jennifer J. S. Brooks and Ronald J. Schultz, Market Theory: An Approach to Real Property Valuation for State and Local Tax Purposes, 45 TAX LAW. 339, 350-351 (1992).)

we accept appellant's determination of the reasonable market rental rates for the GOPO property during the appeal years, as modified above.

Accordingly, respondent's action in this matter must be modified to reflect the foregoing opinion.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Union Carbide Corporation against proposed assessments of additional franchise tax in the amounts of $292,313, $261,473, $569,090, $352,129, $513,225, and $554,043 for the income years 1974, 1975, 1976, 1977, 1978, and 1979, respectively, be and the same is hereby modified in accordance with the foregoing opinion.

Done at Sacramento, California, this 13th day of January, 1993, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong, Mr. Dronenburg and Ms. Scott present.

Brad Sherman, Chairman

Matthew K. Fong, Member

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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